

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-104072-97]

RIN 1545-AV07

Recharacterizing financing arrangements involving fast-pay stock.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that recharacterize, for tax purposes, financing arrangements involving fast-pay stock. The regulations are necessary to prevent taxpayers from using fast-pay stock to achieve inappropriate tax avoidance. The regulations affect corporations that issue fast-pay stock, holders of fast-pay stock, and other shareholders that may claim tax benefits purported to result from arrangements involving fast-pay stock. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by April 6, 1999.

Outlines of topics to be discussed at the public hearing scheduled for April 8, 1999, at 10 a.m. must be received by March 18, 1999.

ADDRESSES: Send submissions: to CC:DOM:CORP:R (REG-104072-97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to:

CC:DOM:CORP:R (REG-104072-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

Alternatively, taxpayers may submit comments via the Internet by selecting the "Tax Regs" option of the IRS Home Page or by submitting them directly to the IRS Internet site at

[http://www.irs.ustreas.gov/prod/tax\\_regs/comments.html](http://www.irs.ustreas.gov/prod/tax_regs/comments.html). The public hearing will be held in room 2615, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jonathan Zelnik at (202) 622-3940; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita VanDyke at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information

should be received by March 8, 1999. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the collection will have a practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information is in §1.7701(1)-3(f) and §1.7701(1)-3(g). The collection of information is mandatory. The likely respondents are individuals, businesses, and other organizations.

Estimated total annual burden: 50 hours

Estimated average annual burden per respondent: 1 hour

Estimated number of respondents: 50

Estimated annual frequency of responses: Annually

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax information are confidential, as required by 26 U.S.C. 6103.

### **Background**

On February 27, 1997, the IRS issued Notice 97-21, 1997-1 C.B. 407, which relates to financing arrangements involving fast-pay stock. Among other things, the notice informs the public that the IRS and Treasury Department expect to issue regulations recharacterizing these arrangements to prevent tax avoidance. Notice 97-21 requested comments, but none have been received.

### **Explanation of Provisions**

#### **A. TAX-AVOIDANCE ARRANGEMENTS USING FAST-PAY STOCK**

Notice 97-21 addresses two-party financing arrangements that are structured as multi-party arrangements to let one or more of the parties avoid tax. Instead of one party directly providing financing to the other, they both acquire stock (with different characteristics) in a conduit entity. The arrangement is structured so that the party providing the financing has a decreasing claim on the conduit entity (and its assets) while the party receiving the financing has an increasing claim on the

conduit entity (and its assets). Economically, both parties benefit from the conduit entity's income. For tax purposes, however, the entity's income is allocated almost entirely to the party providing the financing, allowing the other party to claim unwarranted tax benefits.

Notice 97-21 describes in detail a typical fast-pay stock financing arrangement. The parties to the arrangement include: (1) a person seeking financing (the sponsor), (2) investors who are willing to provide financing and typically are not subject to federal income tax (the investors), and (3) a corporation that is generally subject to tax only at the shareholder level (a conduit entity). The conduit entity issues a class of self-amortizing stock (the fast-pay stock) to the investors and a class of other stock (the benefited stock) to the sponsor. The fast-pay stock is structured so that during an initial period, the dividends made with respect to the stock are substantial and relatively certain while the dividends made with respect to the benefited stock are insignificant. After the initial period, the dividend rate of the fast-pay stock, the stock's effective redemption value, or both, decline.

Economically, the fast-pay stock is self-amortizing because the distributions made with respect to the fast-pay stock are in part a return on the investors' investment and in part a return of their investment. For tax purposes, however, the parties characterize the fast-pay stock distributions entirely as dividends (that is, entirely as a return on the investment).

Consequently, the investors' reported taxable income -- overstated dividend income followed by an overstated capital loss on disposition of the fast-pay stock -- fails to clearly reflect their economic income. (Investors that are tax-exempt suffer no disadvantage from this arrangement.)

Characterizing the distributions made with respect to the fast-pay stock solely as dividends has the corresponding effect of understating the taxable income on the benefited stock (the stock held by the sponsor) during the initial period. Instead of receiving dividends attributable to its share of the conduit entity's income, the sponsor's economic income takes the form of an increasing ownership interest in the conduit entity. Because the fast-pay stock is economically self-amortizing, each distribution reduces the investors' claim on the conduit entity (and its assets) and increases the sponsor's claim. By treating a fast-pay arrangement according to its form, the sponsor reports taxable income that fails to clearly reflect its economic income. An individual sponsor, for example, reports little or no dividend income. Instead, the individual reports gain on disposing of its benefited stock; thus, deferring tax on its economic income and converting that income from ordinary to capital. A corporate sponsor not only reports little or no dividend income, but can avoid reporting gain on the disposition of its benefited stock, thereby entirely eliminating tax on its economic income. (If a corporate sponsor has a sufficient interest in the conduit entity, the sponsor may succeed to the conduit entity's assets

tax-free by liquidating or reorganizing the conduit entity; thus, avoiding a taxable disposition of the benefited stock).

In substance, the investors (the fast-pay shareholders) are financing the sponsor's investment in the conduit entity. Although nominally shareholders in the conduit entity, the investors have a limited, diminishing claim to the entity (and its assets). The sponsor's claim, by contrast, is residual and long-term. Thus, a fast-pay arrangement is effectively a leveraged arrangement in which the sponsor uses untaxed income from the conduit entity to repay the investors.

## B. THE PROPOSED REGULATIONS

### 1. In General

To prevent the avoidance of tax, the Secretary may issue regulations under section 7701(l) recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of the parties. The proposed regulations exercise this authority by recharacterizing certain fast-pay arrangements. A fast-pay arrangement is any financing arrangement in which a corporation has outstanding two or more classes of stock, one of which is fast-pay stock. The regulations identify fast-pay arrangements and recharacterize certain of them as arrangements directly between the holders of the fast-pay stock and the other shareholders (the benefited shareholders) in the corporation. The regulations also impose reporting requirements on certain corporations with outstanding fast-pay stock and on certain shareholders that participate in fast-pay arrangements. These

reporting requirements apply to all fast-pay arrangements, whether or not they are subject to recharacterization.

Notice 97-21 describes specific models for recharacterizing fast-pay arrangements. For purposes of determining the income of the shareholders of a corporation with outstanding fast-pay stock, these models ignore the separate existence of the corporation and treat the fast-pay shareholders and benefited shareholders as owning the corporation's underlying assets. Although this approach prevents tax avoidance, the IRS and Treasury Department have concluded that it may not best reflect the financing relationship between the fast-pay shareholders and the benefited shareholders. In addition, the approach of the notice may be difficult for taxpayers to apply if the corporation has a complex capital structure, multiple assets (including active businesses), or both.

To address these concerns, the proposed regulations treat the fast-pay shareholders as acquiring instruments issued by the benefited shareholders instead of acquiring interests in the assets of the corporation. This approach better reflects the financing relationship between the fast-pay shareholders and the benefited shareholders. It also removes the burden of determining each party's ownership interest in the assets of the corporation. Thus, the regulations provide an approach that is easier to apply and more narrowly tailored than the models described in Notice 97-21.

## 2. Fast-Pay Stock and Benefited Stock

Under the proposed regulations, stock is fast-pay stock if it is structured to provide for dividends that economically represent a return (in whole or in part) of the holder's investment rather than only a return on the holder's investment. Stock is presumed to be fast-pay stock if it has, by design, a dividend rate that is reasonably expected to decline, or an issue price that exceeds the amount at which the holder can be compelled to dispose of the stock. A taxpayer may rebut these presumptions only by clearly showing that no dividend represents an economic return (in whole or in part) of the holder's investment.

Generally, whether stock is fast-pay stock must be determined based on all the facts and circumstances, including any related agreements such as options or forward contracts. A related agreement is any direct or indirect, oral or written, agreement between the holder of the stock and the issuing corporation, or between the holder of the stock and one or more other shareholders in the corporation. The determination that stock is fast-pay stock is made when the stock is issued, and whenever there is a significant modification in the terms of the stock or the related agreements, or a significant change in the relevant facts and circumstances.

The proposed regulations define benefited stock by reference to fast-pay stock. With respect to a class of fast-pay stock, all other stock in the corporation (including any other class of

fast-pay stock) is benefited stock. For fast-pay arrangements in which there is more than one class of benefited stock, the parties must apply the general recharacterization rules among the different classes as appropriate to match the arrangement's economic substance.

### 3. Fast-Pay Arrangements Subject to Recharacterization

Under the proposed regulations, if the corporation with outstanding fast-pay stock is either a regulated investment company (RIC) or a real estate investment trust (REIT), the fast-pay arrangement is automatically recharacterized. If the corporation is neither a RIC nor a REIT, the Commissioner may (at the Commissioner's discretion) recharacterize the fast-pay arrangement in cases where the Commissioner determines that a principal purpose for the structure of the fast-pay arrangement is the avoidance of tax. This rule applies to all parties to a fast-pay arrangement, without regard to whether such parties acquired their interests as part of an initial offering or later (by purchase or other transfer).

By not automatically recharacterizing all fast-pay arrangements, the regulations prevent taxpayers from using the recharacterization rules for other tax avoidance purposes. For example, shareholders of a controlled foreign corporation cannot circumvent the purposes of United States tax law (including treaties) by using the recharacterization rules to exploit inconsistencies between the treatment of a fast-pay arrangement by the United States and foreign jurisdictions. It is expected

that the Commissioner will closely scrutinize fast-pay arrangements in which the corporation with outstanding fast-pay stock is a foreign corporation.

#### 4. Model for Recharacterizing Fast-Pay Arrangements

##### a. In General

The proposed regulations treat the fast-pay shareholders as holding financing instruments issued by the benefited shareholders rather than as holding fast-pay stock in the corporation. The corporation is the paying agent on the financing instruments but has no other relationship to the fast-pay shareholders.

Under the proposed regulations, the financing instruments have the same payment terms as the fast-pay stock. The timing and amount of payments made with respect to the financing instruments, therefore, match the timing and amount of distributions made with respect to the fast-pay stock. Nothing in the regulations characterizes the financing instruments. The character of the financing instruments (for example, stock or debt) must be determined under general tax principles and depends on all the facts and circumstances.

The benefited shareholders are treated as first issuing the financing instruments in exchange for cash equal to the fair market value of the fast-pay stock (taking into account any related agreements), and then as contributing the cash to the corporation (thereby increasing their basis in the benefited stock). Distributions made with respect to the fast-pay stock

are treated as first made with respect to the benefited stock, and then as used by the benefited shareholders to make payments on the financing instruments.

b. Rule for Multiple Classes of Benefited Stock

The proposed regulations do not describe detailed rules for fast-pay arrangements in which there is more than one class of benefited shareholders. Instead, as mentioned before, the regulations provide a general rule that requires recharacterization among the different classes as appropriate to match the economic substance of the fast-pay arrangement.

c. Rules for Disposition of Benefited Stock

The proposed regulations provide special rules for dispositions of benefited stock. On the sale of benefited stock, in addition to any consideration actually received, the seller is treated as receiving the amount necessary to terminate its position with respect to the financing instruments at fair market value. Similarly, the buyer is treated as paying that amount and as issuing new financing instruments to the fast-pay shareholders.

d. Rule Preserving Pre-effective Date Gain

The proposed regulations provide a special basis adjustment rule to ensure that unrealized gain on benefited stock is not inappropriately eliminated. Because the regulations do not apply to amounts accrued or paid in taxable years ending before February 27, 1997 (pre-effective years), a benefited shareholder will have economic income, but not taxable income, attributable

to pre-effective years if the form of a fast-pay arrangement is respected for those years. This economic income is reflected as unrealized gain in the benefited stock.

Absent a special basis adjustment rule, the general recharacterization rule would eliminate this unrealized gain. Although the regulations do not apply to amounts accrued or paid in pre-effective years, the regulations recharacterize fast-pay arrangements from their inception. Thus, in cases in which the fast-pay arrangement was entered into in a pre-effective year, the general recharacterization rule increases a benefited shareholder's basis in its stock as of the inception of the transaction, even though the regulations do not require the benefited shareholder to include deemed dividend distributions attributable to the pre-effective years. Consequently, this increase in basis without corresponding dividend income eliminates the unrealized gain from the pre-effective years.

To preserve the unrealized gain resulting from the economic income attributable to pre-effective years, the proposed regulations provide a special basis adjustment rule. After taking into account any basis increase under the general rule, a benefited shareholder must decrease its basis in its benefited stock by the amount (if any) that (1) its taxable income attributable to the fast-pay arrangement for pre-effective years, computed by recharacterizing the fast-pay arrangement under the regulations, exceeds (2) its taxable income attributable to the fast-pay arrangement for pre-effective years, computed without

applying the recharacterization rules of the regulations. In this way, a benefited shareholder's economic income attributable to taxable years before the effective date of the regulations is not eliminated by the basis provisions of the general recharacterization rules and may be realized when the benefited shareholder disposes of its benefited stock.

e. Rule Prohibiting the Affirmative Use of These Regulations to Avoid Tax Imposed by the Code

The proposed regulations prohibit a taxpayer from affirmatively using the automatic recharacterization rules if a principal purpose for using such rules is the avoidance of any tax imposed by the Code. With respect to such a taxpayer, the Commissioner may depart from the automatic recharacterization rules and treat (for all purposes of the Code) the fast-pay arrangement in accordance with its form or its economic substance. This anti-abuse rule applies on a taxpayer-by-taxpayer basis. For example, if a foreign person acquires fast-pay stock in a REIT and a principal purpose for acquiring such stock is to reduce United States withholding taxes by applying the automatic recharacterization rules, the Commissioner may, for purposes of determining the foreign person's United States tax consequences (namely, withholding tax), depart from the automatic recharacterization rules and treat the foreign person as holding fast-pay stock in the REIT.

5. Withholding

A corporation that issues fast-pay stock is a withholding agent for payments made (or deemed made) under a fast-pay arrangement. Generally, if a fast-pay arrangement is recharacterized under the automatic recharacterization rules, a withholding agent must withhold in accordance with the transaction as recharacterized. A different rule applies, however, if the withholding agent knows or has reason to know that any taxpayer entered into the fast-pay arrangement with a principal purpose of using the recharacterization rules to avoid tax under section 871(a) or section 881. In that case, for each payment made (or deemed made) to such taxpayer under the arrangement, the withholding agent must withhold under section 1441 or section 1442 the higher of (1) the amount of withholding that applies to such payment determined under the form of the arrangement, or (2) the amount of withholding that applies to such payment determined under the automatic recharacterization rules. Also, when the withholding agent knows or has reason to know that the Commissioner has exercised the discretion to depart from the automatic recharacterization rules for a taxpayer, the withholding agent must withhold on payments made (or deemed made) to that taxpayer in accordance with the characterization of the fast-pay arrangement imposed by the Commissioner.

The withholding agent's liability to withhold on payments to foreign individuals is described in new proposed §1.1441-7(g).

The same rules apply to payments (or deemed payments) to foreign corporations under §1.1442-1.

6. Reporting Requirements

In general, a corporation that has fast-pay stock outstanding at any time during the taxable year must attach a statement to its federal income tax return. This rule does not apply to a corporation that is a controlled foreign corporation (CFC) as defined in section 957, a foreign personal holding company (FPHC) as defined in section 552, or a passive foreign investment company (PFIC) as defined in section 1297. Instead, certain shareholders (and officers and directors of FPHCs) of those corporations must attach a statement to their returns.

The statement must identify the corporation that has outstanding fast-pay stock and must recite the terms of the fast-pay stock and the date on which the fast-pay stock was issued. In addition, to the extent the filing person knows or has reason to know such information, the statement must contain the names and the taxpayer identification numbers of the shareholders of any class of stock that is not traded on an established securities market as described in §1.7704-1(b).

7. Election to Limit Taxable Income Attributable to a Recharacterized Fast-Pay Arrangement for Taxable Years Ending After February 26, 1997, and Before the Date These Regulations Are Published as Final Regulations in the Federal Register.

The regulations are proposed to be effective February 27, 1997, and to cover all taxable years ending after February 26,

1997. Thus, the regulations will apply to all amounts accrued or paid on or after the first day of the first taxable year ending after February 26, 1997.

Because the proposed effective date relates to the date Notice 97-21 was issued to the public, and because the regulations adopt different recharacterization rules from the ones described in the notice, the regulations permit a shareholder of a recharacterized fast-pay arrangement to limit its taxable income attributable to the arrangement for certain taxable years. Specifically, for taxable years ending after February 26, 1997, and before the date these regulations are finalized, a shareholder may limit its taxable income attributable to a fast-pay arrangement recharacterized under the regulations, to the taxable income that would result if the fast-pay arrangement were recharacterized under Notice 97-21. Any amount excluded under the limit must be included as an adjustment to taxable income in the shareholder's first taxable year that includes the date the regulations are finalized. Under the regulations, a shareholder that has elected to apply the limit must include a statement in its books and records identifying each fast-pay arrangement for which the election was made, and the amount excluded from taxable income under the election for each fast-pay arrangement.

Shareholders who take advantage of the limit enjoy only a deferral of taxable income: Any amount excluded under the limit is later included as an adjustment. Thus, the sole benefit of

making the election is a timing difference. This result is appropriate because over the life of a fast-pay arrangement a shareholder has the same amount of taxable income whether the fast-pay arrangement is recharacterized under Notice 97-21 or under the regulations. The IRS and Treasury Department invite comments concerning the limit and whether there are fast-pay arrangements in which any difference between a shareholder's taxable income determined under Notice 97-21 and the shareholder's taxable income determined under the regulations is other than a timing difference.

Notice 97-21 describes two types of fast-pay arrangements. Hence, calculating the limit requires appropriately recharacterizing the fast-pay arrangement under the notice. In the first type of fast-pay arrangement that the notice describes, the corporation with outstanding fast-pay stock holds income-producing assets issued by a third party. Notice 97-21 treats the benefited shareholders (one of which is called the "sponsor" in the notice) as acquiring the assets of the corporation directly from the sellers of those assets. The notice treats the fast-pay shareholders (called "investors" in the notice) as acquiring the assets of the corporation either from the sellers of those assets or from the benefited shareholders in an income "stripping" transaction. Thus, both the fast-pay shareholders and benefited shareholders are regarded as owning directly the corporation's assets.

In the second type of fast-pay arrangement that Notice 97-21 describes, the corporation with outstanding fast-pay stock holds a debt instrument issued by the sponsor (a benefited shareholder). In this situation, the notice treats the sponsor as having issued one or more instruments directly to the holders of the fast-pay stock. Thus, for purposes of determining the sponsor's taxable income, the sponsor's obligation under any asset held by the corporation is ignored.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in E.O. 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the understanding of the IRS and Treasury Department that the total number of fast-pay arrangements is fewer than 100, that the number of entities engaging in transactions affected by these regulations is not substantial and, of those entities, few or none are small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small businesses.

### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. The IRS and Treasury Department specifically request comments on the clarity of the proposed rule and how it may be made easier to understand.

A public hearing has been scheduled for April 8, 1999, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10<sup>th</sup> Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit written comments by April 6, 1999, and submit an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by March 18, 1999.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### **Proposed Effective Date**

These regulations are proposed to be effective February 27, 1997, and apply to taxable years ending after February 26, 1997. Thus, all amounts accrued or paid on or after the first day of the first taxable year ending after February 26, 1997, will be subject to the regulations, regardless of when a particular share of the stock or a particular debt instrument was issued.

The statement required under §1.7701(l)-3(f) is proposed to apply to taxable years (of the taxpayer required to file the statement) ending after the date the regulations are published as final regulations in the Federal Register.

#### **Drafting Information**

The principal authors of these regulations are Jonathan Zelnik and Marshall Feiring of the Office of the Assistant Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

#### **List of subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

#### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.7701(l)-3 also issued under 26 U.S.C. 7701(l).

\* \* \*

Par. 2. Section 1.1441-7 is amended as follows:

1. Paragraph (g) is redesignated as paragraph (h) and is revised.

2. New paragraph (g) is added.

The addition and revision read as follows:

§1.1441-7 General provisions relating to withholding agents.

\* \* \* \* \*

(g) Fast-pay arrangements--(1) In general. A corporation that issues fast-pay stock in a fast-pay arrangement described in §1.7701(l)-3(b)(1) is a withholding agent with respect to fast-pay dividends paid under the arrangement and any deemed payments with respect to the arrangement under the recharacterization rules of §1.7701(l)-3(c). Except as provided in this paragraph (g)(1) or in paragraph (g)(2) of this section, the withholding tax rules under section 1441 and section 1442 apply with respect to a fast-pay arrangement described in §1.7701(l)-3(c)(1)(i) in accordance with the recharacterization rules provided in §1.7701(l)-3(c). In all cases, notwithstanding paragraph (g)(2)

of this section, if at any time the withholding agent knows or has reason to know that the Commissioner has exercised the discretion under §1.7701(1)-3(d) to depart from the recharacterization rules of §1.7701(1)-3(c) for a taxpayer, the withholding agent must withhold on payments made (or deemed made) to that taxpayer in accordance with the characterization of the fast-pay arrangement imposed by the Commissioner under §1.7701(1)-3(d).

(2) Exception. If at any time the withholding agent knows or has reason to know that any taxpayer entered into a fast-pay arrangement with a principal purpose of applying the recharacterization rules of §1.7701(1)-3(c) to avoid tax under section 871(a) or section 881, then for each payment made or deemed made to such taxpayer under the arrangement, the withholding agent must withhold, under section 1441 or section 1442, the higher of--

(i) The amount of withholding that would apply to such payment determined under the form of the arrangement; or

(ii) The amount of withholding that would apply to deemed payments determined under the recharacterization rules of §1.7701(1)-3(c).

(3) Liability. Any person required to deduct and withhold tax under this paragraph (g) is made liable for that tax by section 1461, and is also liable for applicable penalties and interest for failing to comply with section 1461.

(4) Examples. The following examples illustrate the rules of this paragraph (g):

Example 1. REIT W issues shares of fast-pay stock to foreign individual A, a resident of Country C. United States source dividends paid to residents of C are subject to a 30 percent withholding tax. W issues all shares of benefited stock to foreign individuals who are residents of Country D. D's income tax convention with the United States reduces the United States withholding tax on dividends to 15 percent. Under §1.7701(l)-3(c), the dividends paid by W to A are deemed to be paid by W to the benefited shareholders. W has reason to know that A entered into the fast-pay arrangement with a principal purpose of using the recharacterization rules of §1.7701(l)-3(c) to reduce United States withholding tax. W must withhold at the 30 percent rate on the dividends deemed paid to its benefited shareholders because the amount of withholding that applies to such payments determined under the form of the arrangement is higher than the amount of withholding that applies to such payments determined under §1.7701(l)-3(c).

Example 2. The facts are the same as in Example 1 of this paragraph (g)(4) except that W does not know, or have reason to know, that A entered the arrangement with a principal purpose of using the recharacterization rules of §1.7701(l)-3(c) to reduce United States withholding tax. Further, the Commissioner has not exercised the discretion under §1.7701(l)-3(d) to depart from the recharacterization rules of §1.7701(l)-3(c). Accordingly, W must withhold tax at a 15 percent rate on the dividends deemed paid to the benefited shareholders.

(5) Effective date. This paragraph (g) applies to payments made (or deemed made) on or after January 6, 1999.

(h) Effective date. Except as otherwise provided in paragraph (f)(3) or (g)(5) of this section, this section applies to payments made after December 31, 1999.

Par. 3. Section 1.7701(l)-3 is added to read as follows:  
§1.7701(l)-3 Recharacterizing financing arrangements involving fast-pay stock.

(a) Purpose and scope. This section is intended to prevent the avoidance of tax by persons participating in fast-pay

arrangements (as defined in paragraph (b)(1) of this section) and should be interpreted in a manner consistent with this purpose. This section applies to all fast-pay arrangements. Paragraph (c) of this section recharacterizes certain fast-pay arrangements to ensure the participants are taxed in a manner reflecting the economic substance of the arrangements. Paragraph (f) of this section imposes reporting requirements on certain participants.

(b) Definitions--(1) Fast-pay arrangement. A fast-pay arrangement is any arrangement in which a corporation has outstanding for any part of its taxable year two or more classes of stock, at least one of which is fast-pay stock.

(2) Fast-pay stock--(i) Defined. Stock is fast-pay stock if it is structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if--

(A) It is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant); or

(B) It is issued for an amount that exceeds (by more than a de minimis amount, as determined under the principles of §1.1273-1(d)) the amount at which the holder can be compelled to dispose of the stock.

(ii) Determination. The determination of whether stock is fast-pay stock is based on all the facts and circumstances, including any related agreements such as options or forward contracts. A related agreement is any direct or indirect agreement or understanding, oral or written, between the holder of the stock and the issuing corporation, or between the holder of the stock and one or more other shareholders in the corporation. The determination is made when the stock is issued and whenever there is a significant modification in the terms of the stock or the related agreements, or a significant change in the relevant facts and circumstances.

(3) Benefited stock defined. With respect to a class of fast-pay stock, all other stock in the corporation (including any other class of fast-pay stock) is benefited stock.

(c) Recharacterization of certain fast-pay arrangements--

(1) Scope. This paragraph (c) applies to any fast-pay arrangement--

(i) In which the corporation that has outstanding fast-pay stock is a regulated investment company (RIC) (as defined in section 851) or a real estate investment trust (REIT) (as defined in section 856); or

(ii) If the Commissioner determines that a principal purpose for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the Code. Application of this paragraph (c)(1)(ii) is at the Commissioner's discretion, and a

determination under this paragraph (c)(1)(ii) applies to all parties to the fast-pay arrangement, including transferees.

(2) Recharacterization. A fast-pay arrangement described in paragraph (c)(1) of this section is recharacterized as an arrangement directly between the benefited shareholders and the fast-pay shareholders. The inception and resulting relationships of the recharacterized arrangement are deemed to be as follows:

(i) Relationship between benefited shareholders and fast-pay shareholders. The benefited shareholders issue financial instruments (the financing instruments) directly to the fast-pay shareholders in exchange for cash equal to the fair market value of the fast-pay stock at the time of issuance (taking into account any related agreements). The financing instruments have the same payment terms as the fast-pay stock. Thus, the timing and amount of the payments made with respect to the financing instruments always match the timing and amount of the distributions made with respect to the fast-pay stock.

(ii) Relationship between benefited shareholders and corporation. The benefited shareholders contribute to the corporation the cash they receive for issuing the financing instruments. Distributions made with respect to the fast-pay stock are distributions made by the corporation with respect to the benefited shareholders' benefited stock.

(iii) Relationship between fast-pay shareholders and corporation. For purposes of determining the relationship between the fast-pay shareholders and the corporation, the fast-

pay stock is ignored. The corporation is the paying agent of the benefited shareholders with respect to the financing instruments.

(3) Other rules--(i) Character of the financing instruments.

The character of a financing instrument (for example, stock or debt) is determined under general tax principles and depends on all the facts and circumstances.

(ii) Multiple classes of benefited stock. If there is more than one class of benefited stock, the recharacterization rules of this paragraph (c) apply among the different classes as appropriate to match the economic substance of the fast-pay arrangement.

(iii) Sale of benefited stock. If one person sells benefited stock to another--

(A) In addition to any consideration actually paid and received for the benefited stock, the buyer is deemed to pay and the seller is deemed to receive the amount necessary to terminate the seller's position in the financing instruments at fair market value; and

(B) The buyer is deemed to issue financing instruments to the fast-pay shareholders in exchange for the amount necessary to terminate the seller's position in the financing instruments.

(iv) Adjustment to basis for amounts accrued or paid in taxable years ending before February 27, 1997. In the case of a fast-pay arrangement involving amounts accrued or paid in taxable years ending before February 27, 1997, and recharacterized under this paragraph (c), a benefited shareholder must decrease its

basis in any benefited stock (as determined under paragraph (c)(2)(ii) of this section) by the amount (if any) that--

(A) Its income attributable to the benefited stock (reduced by deductions attributable to financing instruments) for taxable years ending before February 27, 1997, computed by recharacterizing the fast-pay arrangement under this paragraph (c); exceeds

(B) Its income attributable to such stock for taxable years ending before February 27, 1997, computed without applying the rules of this paragraph (c).

(d) Prohibition against affirmative use of recharacterization by taxpayers. A taxpayer may not use the rules of paragraph (c) of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Code) the fast-pay arrangement in accordance with its form or its economic substance. For example, if a foreign person acquires fast-pay stock in a REIT and a principal purpose for acquiring such stock is to reduce United States withholding taxes by applying the rules of paragraph (c) of this section, the Commissioner may, for purposes of determining the foreign person's United States tax consequences (namely, withholding tax), depart from the rules of paragraph (c) of this section and treat the foreign person as holding fast-pay stock in the REIT.

(e) Examples. The following examples illustrate the rules of paragraph (c) of this section:

Example 1. Decline in dividend rate. (i) Facts. Corporation X issues 100 shares of A Stock and 100 shares of B Stock for \$1,000 per share. By its terms, a share of B Stock is reasonably expected to pay a \$110 dividend in years 1 through 10 and a \$30 dividend each year thereafter. If X liquidates, the holder of a share of B Stock is entitled to a preference equal to the share's issue price. Otherwise, the B Stock cannot be redeemed at either X's or the shareholder's option.

(ii) Analysis. When issued, the B Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. Since the B Stock is structured to have a declining dividend rate, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 2. Issued at a premium. (i) Facts. The facts are the same as in Example 1 of this paragraph (e) except that a share of B Stock is reasonably expected to pay an annual \$110 dividend as long as it is outstanding, and Corporation X has the right to redeem the B Stock for \$400 a share at the end of year 10.

(ii) Analysis. The B Stock is structured so that the issue price of the B Stock (\$1,000) exceeds (by more than a de minimis amount) the price at which the holder can be compelled to dispose of the stock (\$400). Thus, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 3. Recharacterization illustrated. (i) Facts. On formation, REIT Y issues 100 shares of C Stock and 100 shares of D Stock for \$1,000 per share. By its terms, a share of D Stock is reasonably expected to pay a \$110 dividend in years 1 through 10 and a \$30 dividend each year thereafter. In years 1 through 10, persons holding a majority of the D Stock must consent before Y may take any action that would result in Y liquidating or dissolving, merging or consolidating, losing its REIT status, or selling substantially all of its assets. Thereafter, Y may take these actions without consent so long as the D Stock shareholders receive \$400 in exchange for their D Stock.

(ii) Analysis. When issued, the D Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. In addition, the \$1,000 issue price of a share of D Stock exceeds the price at which the shareholder can be compelled to dispose of the stock (\$400). Thus, the D Stock is fast-pay stock, and the C Stock is benefited stock. Because Y is a REIT,

the fast-pay arrangement is recharacterized under paragraph (c) of this section.

(iii) Recharacterization. The fast-pay arrangement is recharacterized as follows:

(A) Under paragraph (c)(2)(i) of this section, the C Stock shareholders are treated as issuing financing instruments to the D Stock shareholders in exchange for \$100,000 (\$1,000, the fair market value of each share of D Stock, multiplied by 100, the number of shares).

(B) Under paragraph (c)(2)(ii) of this section, the C Stock shareholders are treated as contributing \$200,000 to Y (the \$100,000 received for the financing instruments, plus the \$100,000 actually paid for the C Stock) in exchange for the C Stock.

(C) Under paragraph (c)(2)(ii) of this section, each distribution with respect to the D Stock is treated as a distribution with respect to the C Stock.

(D) Under paragraph (c)(2)(iii) of this section, the C Stock shareholders are treated as making payments with respect to the financing instruments, and Y is treated as the paying agent of the financing instruments for the C Stock shareholders.

Example 4. Transfer of benefited stock illustrated. (i) Facts. The facts are the same as in Example 3 of this paragraph (e). Near the end of year 5, a person holding one share of C Stock sells it for \$1,300. The buyer is unrelated to REIT Y or to any of the D Stock shareholders. At the time of the sale, the amount needed to terminate the seller's position in the financing instruments at fair market value is \$747.

(ii) Benefited shareholder's treatment on sale. Under paragraph (c)(3)(iii)(A) of this section, the seller's amount realized is \$2,047 (\$1,300, the amount actually received, plus \$747, the amount necessary to terminate the seller's position in the financing instruments at fair market value). The seller's gain on the sale of the common stock is \$47 (\$2,047, the amount realized, minus \$2,000, the seller's basis in the common stock). The seller has no income or deduction with respect to terminating its position in the financing instruments.

(iii) Buyer's treatment on purchase. Under paragraph (c)(3)(iii)(A) of this section, the buyer's basis in the share of D Stock is \$2,047 (\$1,300, the amount actually paid, plus \$747, the amount needed to terminate the seller's position in the financing instruments at fair market value). Under paragraph (c)(3)(iii)(B) of this section, simultaneous with the sale, the buyer is treated as issuing financing instruments to the fast-pay

shareholders in exchange for \$747, the amount necessary to terminate the seller's position in the financing instruments at fair market value.

Example 5. Fast-pay arrangement involving amounts accrued or paid in a taxable year ending before February 27, 1997. (i) Facts. Y is a calendar year taxpayer. In June 1996, Y acquires shares of REIT T benefited stock for \$15,000. In December 1996, Y receives dividends of \$100. Under the recharacterization rules of paragraph (c)(2) of this section, Y's 1996 income attributable to the benefited stock is \$1,200, Y's 1996 deduction attributable to financing instruments is \$500, and Y's basis in the benefited stock is \$25,000.

(ii) Analysis. Under paragraph (c)(3)(iv) of this section, Y's basis in the benefited stock is reduced by \$600. This is the amount by which Y's 1996 income from the fast-pay arrangement as recharacterized under this section (\$1,200 of income attributable to the benefited stock less \$500 of deductions attributable to the financing instruments), exceeds Y's 1996 income from the fast-pay arrangement as not recharacterized under this section (\$100 of income attributable to the benefited stock). Thus, in 1997 when the fast-pay arrangement is recharacterized, Y's basis in the benefited stock is \$24,400.

(f) Reporting requirement--(1) Filing requirements--(i) In general. A corporation that has fast-pay stock outstanding at any time during the taxable year must attach the statement described in paragraph (f)(2) of this section to its federal income tax return for such taxable year. This paragraph (f)(1)(i) does not apply to a corporation described in paragraphs (f)(1)(ii), (iii), or (iv) of this section.

(ii) Controlled foreign corporation. In the case of a controlled foreign corporation (CFC), as defined in section 957, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a CFC), each controlling United States shareholder (within the meaning of §1.964-1(c)(5)) must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 5471 for the CFC's taxable

year. The provisions of section 6038 and the regulations under section 6038 apply to any statement required by this paragraph (f)(1)(ii).

(iii) Foreign personal holding company. In the case of a foreign personal holding company (FPHC), as defined in section 552, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a FPHC), each United States citizen or resident who is an officer, director, or 10-percent shareholder (within the meaning of section 6035(e)(1)) of such FPHC must attach the statement described in paragraph (f)(2) of this section to his or her Form 5471 for the FPHC's taxable year. The provisions of sections 6035 and 6679 and the regulations under sections 6035 and 6679 apply to any statement required by this paragraph (f)(1)(iii).

(iv) Passive foreign investment company. In the case of a passive foreign investment company (PFIC), as defined in section 1297, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a PFIC), each shareholder that has elected (under section 1295) to treat the PFIC as a qualified electing fund and knows or has reason to know that the PFIC has outstanding fast-pay stock must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 8621 for the PFIC's taxable year. Each shareholder owning 10 percent or more of the shares of the PFIC (by vote or value) is presumed to know that the PFIC has issued fast-pay stock. The provisions of sections 1295(a)(2) and

1298(f) and the regulations under those sections (including §1.1295-1T(f)(2)) apply to any statement required by this paragraph (f)(1)(iv).

(2) Statement. The statement required under this paragraph (f) must say, "This fast-pay stock disclosure statement is required by §1.7701(l)-3(f) of the income tax regulations." The statement must also identify the corporation that has outstanding fast-pay stock and must contain the date on which the fast-pay stock was issued, the terms of the fast-pay stock, and (to the extent the filing person knows or has reason to know such information) the names and taxpayer identification numbers of the shareholders of any class of stock that is not traded on an established securities market (as described in §1.7704-1(b)).

(g) Effective date--(1) In general. Except as provided in paragraph (g)(4) of this section (relating to reporting requirements), this section applies to taxable years ending after February 26, 1997. Thus, all amounts accrued or paid during the first taxable year ending after February 26, 1997, are subject to this section.

(2) Election to limit taxable income attributable to a recharacterized fast-pay arrangement for taxable years ending after February 26, 1997, and before the date these regulations are published as final regulations in the Federal Register--(i) Limit and adjustment. For taxable years ending after February 26, 1997, and before the date these regulations are published as final regulations in the Federal Register, a shareholder may

limit its taxable income attributable to a fast-pay arrangement recharacterized under paragraph (c) of this section, to the taxable income that would result if the fast-pay arrangement were recharacterized under Notice 97-21, 1997-1 C.B. 407, see §601.601(d)(2) of this chapter. Any amount a shareholder excludes from taxable income under this paragraph (g)(2)(i) must be included as an adjustment to taxable income in the shareholder's first taxable year that includes the date these regulations are published as final regulations in the Federal Register. A shareholder that has elected to limit its taxable income under this paragraph (g)(2)(i) must include a statement in its books and records identifying each fast-pay arrangement to which the limit was applied and providing the amount excluded from taxable income for each such fast-pay arrangement.

(ii) The following examples illustrate the rules of this paragraph (g)(2). For purposes of these examples, assume that the last year a shareholder may limit its taxable income under this paragraph (g)(2) is 1998.

Example 1. Fast-pay arrangement recharacterized under Notice 97-21; REIT holds third-party debt. (i) Facts.

(A) REIT Y is formed on January 1, 1998, at which time it issues 1,000 shares of fast-pay stock and 1,000 shares of benefited stock for \$100 per share. Y and all of its shareholders have calendar taxable years. All shareholders of Y have elected to accrue market discount based on a constant interest rate, to include the market discount in income as it accrues, and to amortize bond premium.

(B) For years 1 through 5, the fast-pay stock has an annual dividend rate of \$17 per share (\$17,000 for the class); in later years, the fast-pay stock has an annual dividend rate of \$1 per share (\$1,000 for the class). At the end of year 5, and

thereafter, a share of fast-pay stock can be acquired by Y in exchange for \$50 (\$50,000 for the class).

(C) On the day Y is formed, it acquires a five-year mortgage note (the note) issued by an unrelated third party for \$200,000. The note provides for annual interest payments on December 31 of \$18,000 (a coupon interest rate of 9.0 percent, compounded annually), and one payment of principal at the end of 5 years. The note can be prepaid, in whole or in part, at any time.

(ii) Recharacterization under Notice 97-21. (A) In general. One way to recharacterize the fast-pay arrangement under Notice 97-21 is to treat the fast-pay shareholders and the benefited shareholders as if they jointly purchased the note from the issuer with the understanding that over the five-year term of the note the benefited shareholders would use their share of the interest to buy (on a dollar-for-dollar basis) the fast-pay shareholders' portion of the note. The benefited shareholders' and the fast-pay shareholders' yearly taxable income under Notice 97-21 can then be calculated after determining their initial portions of the note and whether those initial portions are purchased at a discount or premium.

(B) Determining initial portions of the debt instrument. The fast-pay shareholders' and the benefited shareholders' initial portions of the note can be determined by comparing the present values of their expected cash flows. As a class, the fast-pay shareholders expect to receive cash flows of \$135,000 (five annual payments of \$17,000, plus a final payment of \$50,000). As a class, the benefited shareholders expect to receive cash flows of \$155,000 (five annual payments of \$1,000, plus a final payment of \$150,000). Using a discount rate equal to the yield to maturity (as determined under §1.1272-1(b)(1)(i)) of the mortgage note (9.0 percent, compounded annually), the present value of the fast-pay shareholders' cash flows is \$98,620, and the present value of the benefited shareholders' cash flows is \$101,380. Thus, the fast-pay shareholders initially acquire 49 percent of the note at a \$1,380 premium (that is, they paid \$100,000 for \$98,620 of principal in the note). The benefited shareholders initially acquire 51 percent of the note at a \$1,380 discount (that is, they paid \$100,000 for \$101,380 of principal in the note). Under section 171, the fast-pay shareholders' premium is amortizable based on their yield in their initial portion of the note (8.57 percent, compounded annually). The benefited shareholders' discount accrues based on the yield in their initial portion of the note (9.35 percent, compounded annually).

(C) Taxable income under Notice 97-21. Under Notice 97-21, the fast-pay shareholders' 1998 taxable income attributable to the fast-pay arrangement is \$8,574 (\$8.57 per \$100 invested), computed by subtracting the amortizable premium (\$302) from the

interest income from their portion of the note (\$8,876). The benefited shareholders' 1998 taxable income attributable to the fast-pay arrangement is \$9,353 (\$9.35 per \$100 invested), computed by adding the accrued discount (\$229) to the interest income from their portion of the note (\$9,124).

(iii) Taxable income under the recharacterization of this section. Assume the financing instruments are debt instruments. Under the recharacterization rules of paragraph (c) of this section, the fast-pay shareholders' 1998 taxable income attributable to the fast-pay arrangement is \$8,574 (\$8.57 per \$100 invested), which is the interest income from the financing instruments. The benefited shareholders' 1998 taxable income attributable to the fast-pay arrangement is \$9,426 (\$9.43 per share of benefited stock), computed by subtracting the interest income accrued on the financing instruments (\$8,574) from the dividend income actually and deemed paid on the benefited stock (\$18,000).

(iv) Limit on taxable income under this paragraph (g)(2).  
(A) Fast-pay shareholders. For 1998, the fast-pay shareholders have the same taxable income under the recharacterization of Notice 97-21 (\$8,574) as they have under the recharacterization of paragraph (c) of this section (\$8,574). Thus, the limit under paragraph (g)(2)(i) of this section is unavailable to the fast-pay shareholders.

(B) Benefited shareholders. For 1998, the benefited shareholders have taxable income attributable to the fast-pay arrangement of \$9,353 (\$9.35 per \$100 invested) under the recharacterization of Notice 97-21, and taxable income of \$9,426 (\$9.43 per share of benefited stock) under the recharacterization of paragraph (c) of this section. Thus, under paragraph (g)(2)(i) of this section, a benefited shareholder may elect to limit its taxable income attributable to the fast-pay arrangement to \$9.35 for each share of benefited stock. Any amount an electing shareholder excludes from taxable income (\$0.08 per share of benefited stock) must later be included as an adjustment. (If all benefited shareholders elect the limit, then as a class the later adjustment to taxable income is \$73.)

Example 2. REIT holds debt issued by a benefited shareholder. (i) Facts. The facts are the same as in Example 1 of this paragraph (g)(2) except that corporation Z holds 800 shares (80 percent) of the benefited stock, and Z, instead of a third party, issues the mortgage note acquired by Y.

(ii) Recharacterization under Notice 97-21. Because Y holds a debt instrument issued by Z, the fast-pay arrangement is recharacterized under Notice 97-21 as an arrangement in which Z issued one or more instruments directly to the fast-pay shareholders and the other benefited shareholders. Consistent

with this recharacterization, Z is treated as issuing a debt instrument to the fast-pay shareholders for \$100,000. The debt instrument provides for five annual payments of \$17,000 and an additional payment of \$50,000 in year five. Thus, the debt instrument's yield to maturity is 8.57 percent per annum, compounded annually. Z is also treated as issuing a debt instrument to the other benefited shareholders for \$20,000 (200 shares multiplied by \$100, or 20 percent of the \$100,000 paid to Y by the benefited shareholders as a class). This debt instrument provides for five annual payments of \$200 and an additional payment of \$30,000 in year five. The debt instrument's yield to maturity is 9.30 percent per annum, compounded annually. For 1998, Z's interest expense is \$10,435 (\$8,574 attributable to the debt instruments held by the fast-pay shareholders, and \$1,861 attributable to the debt instruments held by the other benefited shareholders).

(iii) Recharacterization under this section. Assume the financing instruments are debt instruments. Under the recharacterization rules of paragraph (c) of this section, for 1998, Z has dividend income of \$14,400 (800 shares multiplied by \$18, or 80 percent of \$18,000), and total interest expense of \$24,859 (\$18,000 of interest accrued on the note held by Y, and \$6,859 of interest accrued on the financing instruments).

(iv) Limit on taxable income under this paragraph (g)(2). For 1998, Z has a taxable loss attributable to the fast-pay arrangement of \$10,435 under the recharacterization of Notice 97-21, and a taxable loss of \$10,459 (\$14,400 of dividends, minus \$24,859 of total interest expense) under the recharacterization of paragraph (c) of this section. Thus, for 1998, Z's taxable loss attributable to the fast-pay arrangement is \$10,459 (the amount determined under paragraph (c) of this section), and the limit of paragraph (g)(2)(i) of this section is unavailable to Z.

(3) Rule to comply with this section. To comply with this section for each taxable year in which it failed to do so, a taxpayer should file an amended return. For taxable years ending before the date these regulations are published as final regulations, a taxpayer that has complied with Notice 97-21, 1997-1 C.B. 407, (see §601.601(d)(2) of this chapter) is considered to have complied with this section.

(4) Reporting requirements. The reporting requirements of paragraph (f) of this section apply to taxable years (of the person required to file the statement) ending after the date these regulations are published as final regulations in the Federal Register.

Deputy Commissioner of Internal Revenue

/s/ John Dalrymple